

# NMTC MONTHLY REPORT

A MONTHLY PUBLICATION ON THE NEW MARKETS TAX CREDIT INDUSTRY

October 2007 Volume VI, Issue X, Published By Novogradac & Company LLP

## Analyzing QALICB Reserves - Working Capital vs. Nonqualified Financial Property

By Scott A. Lindquist and Jonathan M. Kaden, Sonnenchein Nath & Rosenthal LLP

One of the requirements that a business entity must meet to constitute a qualified active low income community business (QALICB) under Section 45D of the Internal Revenue Code (IRC) is that "less than 5 percent of the average of the aggregate unadjusted bases of the property of such entity is attributable to nonqualified financial property." The term nonqualified financial property is defined generally as "debt, stock, partnership interests, options, futures contracts, forward contracts, warrants, notional principal contracts, annuities, and other similar property ...."

However, certain financial assets are deemed not to constitute nonqualified financial property, including "reasonable amounts of working capital held in cash, cash equivalents, or debt instruments with a term of 18 months or less." In many new markets tax credit (NMTC) transactions, a prospective qualified business will intend to establish, or be required to establish, reserves for various purposes. Such reserves will be held in bank accounts (which represent a debt of the bank to the business) or an investment account of some kind, which would place them within the general definition of nonqualified financial property.

In any case in which such reserves could exceed 5 percent of the assets of the qualified business (on a cost basis), the parties and their counsel need to address whether the reserves will constitute reasonable working capital or, instead, nonqualified financial property. The status of the business as a QALICB, and thus the qualification of the transaction for NMTCs, depends on the answer to this question.

Unfortunately, the term working capital is not defined, either in Section 45D or elsewhere in the IRC or

Treasury regulations. With so little direct authority to go on, one must look to the history of the NMTC statute, the apparent purpose of the restriction on nonqualified financial property, and other definitions of working capital.

There is very little legislative history on Section 45D. In testimony before a House Subcommittee on March 21, 2000, a Treasury Department official stated that a goal of the NMTC program would be "spurring the creation of higher quality jobs," and further observed that community development entities would invest in businesses "likely to produce the greatest social and financial return." However, by itself, this provides little insight into the questions at hand.

Section 45D was patterned closely after the Enterprise Zone (EZ) statute (Sections 1397A, B, and C of the IRC), which provides tax incentives (in the form of accelerated depreciation and non-recognition of certain gains) for investing in certain businesses located in designated enterprise zones (EZ businesses). The two statutes contain very similar criteria for what businesses may qualify, including identical provisions regarding nonqualified financial property and working capital.

The House Budget Committee Report, dated May 25, 1993 on the EZ statute, indicated that "special attention should be given to the problems of distressed urban and rural areas... [including] through expanded business and employment opportunities," and in Senate Subcommittee hearings on June 18, 1993, a Treasury official testified that capital investment tax incentives were to be available only to "enterprise zone business[es]," which is "designed to target the capital incentives to businesses that are likely to have a significant impact in the zone."

(continued on page 2)

# Analyzing QALICB Reserves

(continued from page 1)

From this history and the similarities between the two statutes, one can conclude that, like the EZ statute, the primary goal of Section 45D was to provide incentives to invest in businesses in certain targeted areas (in this case low-income communities) in ways that contribute to the growth of businesses and/or increased employment in those communities. Conversely, both the EZ and NMTC statutes, in addition to placing limitations on nonqualified financial property, also contain limitations on collectibles, developing or holding intangibles for sale or license, and in the NMTC context, vacant land.

Thus, the restrictions on nonqualified financial property may be viewed as part of an overall design to encourage investment in productive assets, such as buildings and equipment, that contribute directly to growth and employment in particular locations, and *not* investments that are passive or intangible in nature. This is underscored by the very low permitted threshold (5 percent) for nonqualified financial property and collectibles.

On the other hand, each statute reflects an understanding that active businesses require reasonable working capital to operate and grow. As noted above, however, working capital is not defined. Because it is an accounting concept, it is logical to look at how this term is defined for accounting purposes.

Chapter 3 of Accounting Research Bulletin 43 issued by the American Institute of Certified Public Accountants (ARB 43) provides that working capital is "the excess of current assets over current liabilities and identifies the relatively liquid portion of total enterprise capital which constitutes a margin or buffer for meeting obligations within the ordinary operating cycle of the business." Generally, this represents capital that is available for use in the business and not restricted for use in non-current operations.

ARB 43 then defines the current assets and current liabilities that determine working capital. "Current assets is used to designate cash and other assets or resources commonly identified as those which are reasonably expected to be realized in cash or sold or consumed during the normal operating cycle of the business." Current assets include "such resources as (a) cash available for current operations and items which are the equivalent of cash; ... (d) receivables ... if collectible in the ordinary course of business within a year; ... and (f) marketable securities representing the investment of cash available for current operations...." However, current assets exclude such resources as "cash and claims to cash which are restricted as to withdrawal or use for other than current operations . . . or are segregated for the liquidation of long-term debts."

(continued on page 3)

## NMTC REPORT EDITORIAL BOARD

### Publisher

Michael J. Novogradac, CPA

### Editor

Jane Bowar Zastrow

### Managing Editor

Alex Ruiz

### Technical Editor

Owen P. Gray, CPA

### Staff Writer

Anne Townsend

### Contributing Writer

Gregory Clements  
Jonathan Kaden  
Scott Lindquist

### Production

Alex Ruiz

## NMTC REPORT INFORMATION

Novogradac & Company LLP  
246 First Street, 5th Floor  
San Francisco, CA 94105  
E-mail: cpas@novoco.com

Address all correspondence and editorial submissions to:  
Jane Bowar Zastrow  
Telephone: 415.356.8034

Address inquiries regarding advertising opportunities to:  
Junhee Byun  
Telephone: 415.356.8037

Editorial material in this publication is for informational purposes only and should not be construed otherwise. Advice and interpretation regarding property valuation or any other material covered in this publication can only be obtained from your tax advisor.

No portion of this material may be reprinted without written permission of Novogradac & Company LLP.

© Novogradac & Company LLP,  
2007

All rights reserved.  
ISSN 1541-2474

**NMTC REPORT  
ADVISORY BOARD**

**Chairman**  
**Thomas G. Tracy**  
Hunter Chase & Company

**Bruce Bonjour**  
Perkins Coie LLC

**Rick Edson**  
Housing Capital Advisors Inc.

**Donald S. Holm III**  
National Trust Community  
Investment Corporation

**Lewis M. Horowitz**  
Lane Powell

**Norris Lozano**  
Portland Family of Funds

**Scott Lindquist**  
Sonnenschein Nath & Rosenthal

**Benson Roberts**  
Local Initiatives Support  
Corporation

**John Simon**  
Sidley Austin Brown & Wood

**Herbert Stevens**  
Nixon Peabody LLP

**Mary Tingerthal**  
Community Reinvestment Fund

**Joseph A. Wesolowski**  
Enterprise Community  
Investment Inc.

**HAS YOUR  
ADDRESS CHANGED?**

We at Novogradac would like to stay in touch so if your contact information has changed, we'd like to know. Call us at 415.356.8037, or log on to [www.newmarketscredits.com](http://www.newmarketscredits.com) and click on the Address Change at the foot of the page. Thank you for helping us keep our records up to date.

## Analyzing QALICB Reserves

*(continued from page 2)*

Under ARB 43, the term current liabilities is “used principally to designate obligations whose liquidation is reasonably expected to require the use of existing resources properly classifiable as current assets .... The term is intended to “include... debts which arise from operations directly related to the operating cycle” and “other liabilities whose regular and ordinary liquidation is expected to occur within a relatively short period of time, usually twelve months...” Current liabilities do not include “debts to be liquidated by funds which have been accumulated in accounts of a type not properly classified as current assets”.

Both the apparent purpose of the restrictions on nonqualified financial property, and the accounting definitions relating to working capital, lead to the same principle in assessing whether or not particular kinds of reserves constitute working capital. Those reserves that are available for use in the current operations of the business should constitute working capital, while those that are not so available run the risk of being deemed nonqualified financial property.

For example, reserves to cover potential shortfalls in debt service or operating expenses, as well as reserves for normal or periodic maintenance and repairs, should be deemed working capital. These would be consistent with the apparent purpose of the working capital exclusion — allowing businesses to retain adequate capital to fund their operations — and they fit well within the definitions of current assets and current liabilities used to define working capital for accounting purposes.

However, reserves that are not permitted to be used in the current operations of the business could be regarded as the kind of financial assets that the nonqualified financial property limitation was intended to capture, namely, investments that are passive or intangible in nature that would not be contributing directly to the growth of the business in the low-income community or helping to increase employment there. Also, under ARB 43, current assets expressly excludes “cash and claims to cash which are restricted as to withdrawal or use for other than current operations,” and therefore reserves that are so restricted would not be counted in determining the working capital of the business for accounting purposes.

NMTC transactions and the reserves involved vary considerably, so a determination of whether particular reserves will be deemed working capital or not must take into account the facts involved in each case. The policies behind the NMTC statute and even the technical accounting definitions allow considerable latitude for interpretation. But the discussion above should at least provide a useful framework for analyzing this issue.

Finally, only “reasonable” working capital is excluded from non-

*(continued on page 4)*

# Analyzing QALICB Reserves

(continued from page 3)

qualified financial property. Therefore, even in situations where the business is able to use the funds in its operations, it may not accumulate or hold amounts that exceed what is reasonably needed for that purpose.

Where there are reserves that if treated as nonqualified financial property would exceed the 5 percent limit, the parties face a difficult question regarding whether the entire amount of the reserve is reasonable working capital and, if not, where to draw the line. This is a factual question dependent upon the circumstances of the transaction. If the reserves are tied to specific needs in amounts that are known or can reasonably be predicted, or if there are established industry norms for such reserves, then this can provide a basis for determining that the reserve amounts are reasonable. Absent such factors, however, it would be prudent to structure the transaction in a manner that keeps the reserve amounts under the 5 percent limit. ❖

*Scott Lindquist is a partner in the Chicago office of Sonnenchein Nath & Rosenthal LLP. A substantial portion of his practice is devoted to representation of a wide variety of clients in the new markets tax credit area. Jonathan Kaden is a partner in the Chicago office of Sonnenschein Nath & Rosenthal LLP. He regularly represents investors, CDEs and lenders in connection with new markets tax credit transactions.*

---

*This article first appeared in the October 2007 issue of Novogradac & Company's NMTC Monthly Report and is reproduced here with the permission of Novogradac & Company LLP.*

© Novogradac & Company LLP 2007 - All Rights Reserved.

*Notice pursuant to IRS regulations: Any U.S. federal tax advice contained in this article is not intended to be used, and cannot be used, by any taxpayer for the purpose of avoiding penalties under the Internal Revenue Code; nor is any such advice intended to be used to support the promotion or marketing of a transaction. Any advice expressed in this article is limited to the federal tax issues addressed in it. Additional issues may exist outside the limited scope of any advice provided – any such advice does not consider or provide a conclusion with respect to any additional issues. Taxpayers contemplating undertaking a transaction should seek advice based on their particular circumstances.*

*This editorial material is for informational purposes only and should not be construed otherwise. Advice and interpretation regarding property compliance or any other material covered in this article can only be obtained from your tax advisor. For further information visit [www.newmarketscredits.com](http://www.newmarketscredits.com).*